Department of Finance Canada
Ministère des Finances Canada

Corporate Governance of Financial Institutions

Financial Institutions Division, Department of Finance Consultation Paper

January 2003

Canada

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Preface

The purpose of this paper is to set out the Department of Finance's ("Department") proposals to update the corporate governance framework for financial institutions. The paper is directed to two specific matters in this regard:

- the need to examine whether the changes made to the *Canada Business Corporations Act* (CBCA) and the *Canada Cooperatives Act* (CCA) in Bill S-11 should be reflected in the financial institutions legislative framework; and
- the need to review the corporate governance framework as it applies to policyholders of insurance companies in light of the recent developments in the insurance industry, including demutualization.

It must be emphasized from the outset that the paper is not intended to address corporate governance issues raised as a result of recent corporate scandals in the United States.

These events have impacted not only U.S. markets, but also global markets, including Canada. In response, governments, regulators and the private sector in Canada have been working on measures to improve investor confidence. The Department of Finance is closely following these developments and is maintaining an evergreen progress report on these initiatives on its Web site, entitled *Fostering Confidence in Canada's Capital Markets.*

We recognize that the broader work on investor confidence could have implications for the proposals contained in this paper. Adjustments to the proposals may therefore be necessary to ensure a cohesive and up-to-date corporate governance framework is maintained.

CORPORATE GOVERNANCE

CHAPTER 1
FRAMEWORK AND OBJECTIVES FOR REVIEW

Introduction

Good corporate governance practices are essential to the effectiveness, competitiveness and safety and soundness of financial institutions. Maintaining and promoting strong, efficient and profitable financial institutions is vital to Canada's economic success.

Federal financial institutions legislation recognizes the important role of good governance practices by setting out the key requirements expected of a financial institution in this area. Included among these requirements are rules relating to the rights of shareholders and policyholders, the role of directors, auditors and other advisers, and rules relating to the preparation, review and disclosure of information.

In examining changes to the governance framework, it is important to note that the legislation sets minimum, rather than maximum, standards in this area. An effective legislative structure provides a strong foundation upon which institutions and their stakeholders may build their own corporate governance practices that may be tailored to meet their particular needs and circumstances.

Need for Review

General Corporate Governance Provisions

Financial institutions are recognized as being among the industry leaders in the area of corporate governance. For financial institutions to continue to take the lead in maintaining these high standards, it is important that improvements be introduced to the legislative framework to ensure it is up to date with current developments and practices. A number of important amendments were made to the *Canada Business Corporations Act* (CBCA) and the *Canada Cooperatives Act* (CCA) in 2001 relating to

corporate governance.[1] These amendments were designed to expand shareholder rights, enhance global competitiveness, clarify responsibilities, eliminate duplication and reduce costs.

The corporate governance provisions of the CBCA serve as a reference point for the governance rules in the federal financial institutions legislation. The changes made to the CBCA provisions are now being assessed by the Department in the context of the policy framework for the financial services sector.

The Department's assessment of these changes will be guided by the following key objectives:

- enhancing the effectiveness of the corporate governance rules of financial institutions;
- clarifying the roles and responsibilities of the various participants in the governance system;
- enhancing safety and soundness; and
- fostering competitiveness and innovation of financial institutions.

Corporate Governance Provisions Aimed at Policyholders

The Department is also assessing the corporate governance provisions applicable to policyholders under the *Insurance Companies Act* (ICA) as part of this review. A review of these provisions, which are unique to insurance companies, supplements the revisions to the CBCA noted above for these companies. These concern particularly holders of participating ("par") policies, who are entitled to participate in the profits of the company.

It is appropriate to now assess the policyholder governance provisions of insurance companies to ensure that they remain of the highest order in light of recent developments in the insurance sector. In particular, the recent demutualization of five of Canada's largest mutual life insurance companies, four of which federally incorporated, has resulted in significant corporate and economic changes to the sector.

Another development deserving consideration is the fact that the sale of par policies is steadily decreasing as insurers increasingly sell more non-par products. As sales of par policies have declined, there has also been an increase in the prevalence of "adjustable policies" where future insurance costs, or other key elements of the contract, can be adjusted at the discretion of the company, in a fashion similar to the declaration of dividends of par policies, and with similar effects.

The Department's proposals for consultation in some cases involve streamlining provisions, and in other areas involve changing or adding provisions to better

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[1] These amendments came into force on November 24, 2001.

protect the interests of voting policyholders. We also invite comments on governance proposals relating to adjustable policies.

In reviewing the corporate governance provisions aimed at policyholders[2] the following key principles will be taken into account:

- providing for fair consideration of policyholders' interests;
- reflecting, in an appropriate and practical way, policyholders' interests in corporate governance;
- enhancing the effectiveness of policyholder corporate governance rights; and
- promoting the efficiency of the policyholder governance framework.

Outline of the Paper

The paper is divided into two main parts:

Chapter 2 focuses on broad proposals relating to the corporate governance framework of the federal financial institutions statutes as set out in the *Bank Act*, the *Cooperative Credit Associations Act*, the *Insurance Companies Act*, and the *Trust and Loan Companies Act*.[3]

Chapter 3 concerns the corporate governance provisions aimed at policyholders under the ICA. This chapter focuses on streamlining and improving the effectiveness of policyholder governance rights.

Two annexes are also appended to the paper. Annex A develops in more detail the policy proposals discussed in Chapter 2 of the paper. Annex B outlines other technical changes to the corporate governance rules that are being assessed as part of this review.

The proposals outlined in this paper reflect the views of officials of the Financial Institutions Division, Department of Finance, and are for discussion only. With the release of this paper, officials will be consulting with the financial community

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[2] Note that the proposals in respect of par policies are intended to generally apply to all such policies, including those in closed funds established at the time of demutualization.

[3] Unless otherwise indicated, the proposals in this paper are discussed in terms that generally apply to all of the respective statutes. It is recognized that in certain cases adjustments to these proposals may be required to reflect the unique characteristics of a specific statute.

While bank holding companies and insurance holding companies are not financial institutions, the references to financial institutions in this chapter should also be considered to include references to bank holding companies and to insurance holding companies, where appropriate.

and other interested parties to discuss these proposals. The Department looks forward to hearing the views of interested parties on these proposals.

Written comments should be forwarded, by March 31, 2003 to:

Gerry Salembier
Director, Financial Institutions Division
Department of Finance
140 O'Connor Street
Ottawa, Ontario, K1A 0G5.[4]

Subject to the consent of the submitting party, comments will be posted on the Department of Finance web site at www.fin.gc.ca to add to the transparency and interactivity of the process. Once received by the Department, all submissions will be subject to the *Access to Information Act*, and may be disclosed in accordance with its provisions. Should you express an intention that your submission should be considered confidential, the Department will make all efforts to protect this information within the legal requirements of the law.

[4] Written comments may also be sent by facsimile to (613) 943-1334 or by e-mail to governance-gouvernance@fin.gc.ca.

CHAPTER 2
GENERAL GOVERNANCE PROVISIONS

INTRODUCTION

As noted earlier, the corporate governance provisions of the CBCA serve as the reference point for similar provisions under the federal financial institutions legislation. This chapter focuses on assessing the implications of the CBCA changes in the context of financial institutions.

The chapter is divided into the following subject areas: clarifying the role of directors, enhancing the rights of shareholders and modernizing corporate governance practices.

I. CLARIFYING THE ROLE OF DIRECTORS

Overview

An effective board of directors is key to protecting the best interests of a financial institution. The financial institutions legislation recognizes the importance of the board by setting out the standards, qualifications and duties expected of directors of financial institutions.

This part focuses on proposals to clarify the role of directors in carrying out this important function.

Proposals for Consultation

1. Due Diligence

Directors[5] are subject to a number of duties under the federal financial institutions legislation. If directors fail to fulfill these duties, they may be held liable for damages. Imposing liability is consistent with the objective of ensuring that directors are attentive to complying with their responsibilities under the legislation.

Imposing liability on directors who may have taken steps to comply with their obligations, however, raises fairness concerns. To respond to these concerns, a good governance framework should provide directors with the opportunity to raise defences to demonstrate how they have fulfilled their legislative responsibilities.

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[5] The references to directors in this part should also be considered to include references to officers and auditors, where appropriate.

Under the current financial institutions legislation, directors are permitted to raise a defence of "good faith" reliance on the written advice of professionals.

A concern with this defence, however, is that it does not expressly take into account other actions ("due diligence") that may have been taken by directors, such as setting up appropriate policies and procedures, to fulfill their responsibilities under the legislation. It also fails to recognize that directors must often make decisions on the basis of subjective analysis, and not simply through reliance on the written reports of professionals. The absence of an express due diligence defence in the legislation may have implications on the ability of institutions to recruit directors to act on their behalf.

To address these concerns, the CBCA was amended to provide for an express due diligence defence. This defence is intended to promote fairer treatment for directors by allowing them to show the proactive steps they have taken to fulfill their duties under the Act.

Proposal: To introduce an express due diligence defence in the financial institutions legislation to complement the good faith reliance defence that is currently provided.

2. Indemnification of Directors' Costs

Federal financial institutions are currently permitted to indemnify directors for certain costs in proceedings that are related to the carrying out of their responsibilities. For example, indemnification could be made for legal costs incurred by a director in a court proceeding so long as certain conditions are met, such as acting honestly and in good faith with a view to the best interests of the financial institution.

The provisions are not clear, however, on whether an institution can indemnify a director for costs incurred in an investigative proceeding, or whether expenses can be paid by an institution in advance of the conclusion of any proceeding. As these types of proceedings can be lengthy and complex, directors could be exposed to significant costs.

The recent amendments to the CBCA responded to this concern by clarifying that a company may indemnify a director for costs incurred in an investigative proceeding and may advance funds to directors for costs incurred prior to the conclusion of any type of proceeding. A more detailed description of these changes is set out in Annex A of this paper.

Proposal: To introduce similar changes to the indemnification provisions in the financial institutions legislation.

3. Conflicts of Interest

As noted earlier, directors are under an obligation to act in the best interests of a financial institution. Conflict of interest rules are imposed to address situations in which a director's ability to fairly consider the financial institution's interests could be

compromised by self-interest. These rules cover issues such as disclosure, limitations on voting rights, approval requirements, and accounting for profits. The CBCA was amended to clarify, and in certain cases to expand, the conflict of interest provisions relating to directors and officers of a company. For example, amendments were introduced to impose an ongoing obligation on directors to bring material changes in their interests to the attention of the board and to expressly permit shareholders to gain access to conflict of interest information relating to directors. A more detailed description of these changes is set out in Annex A.

Proposal: To introduce similar changes to the conflict of interest provisions in the financial institutions legislation.

4. Modified Proportionate Liability

Background

Under the current financial institutions legislation a person who has suffered a loss ("injured party") is entitled to recover damages on a joint and several basis from any person who has been found responsible for contributing to that loss. This means that even though an injured party's loss may have been caused by a number of different people, the injured party can elect to recover all of his or her damages against any one of the persons found liable.

Where a person is found to be responsible for only a small percentage of an injured party's loss, and yet is required to pay all of the damages, that person can recover the difference from other individuals or companies who contributed to the injured party's loss. Professionals employed in the preparation of financial information have raised a concern, however, that if the other individuals or companies who are responsible for the loss are insolvent or unavailable, the person paying may not be able to make up the shortfall. This could result in professionals ultimately paying a disproportionately large percentage of the injured party's damages.

Amendments to the CBCA

The CBCA was amended to address this issue by introducing a system of modified proportionate liability ("MPL") into the Act. The new MPL regime applies to cases involving economic loss arising from an error in the preparation of financial information under the Act. The intent of the new regime is to limit the amount of damages that a person is required to pay to their degree of responsibility for the loss.

This change reduces the exposure of persons to liabilities arising from the preparation of financial information under the CBCA. Addressing this issue responded to a concern that certain companies, particularly those in higher risk segments of the economy or in financial difficulty, may experience difficulties in attracting auditors, directors, managers, legal counsel, etc. to act for the company due to the risk of exposure to liability.

One of the implications of moving away from a joint and several liability regime, however, is the impact on injured parties. Under joint and several liability, injured parties are provided a degree of protection against risk of loss in cases where individuals or companies responsible for their damages may be insolvent or unavailable (i.e. the solvent individuals or companies responsible for the injured party's loss are required to pay). Under an MPL regime, however, the risk of loss is effectively transferred from solvent and available individuals or companies responsible for the loss to the injured party. The issue is whether such a transfer of risk is appropriate in all cases.

This issue was addressed under the CBCA by providing exemptions from the MPL rules to allow certain injured parties to continue to utilize the joint and several liability regime. More specifically, the legislation provides that injured parties such as the Crown, Crown corporations, charitable organizations, unsecured trade creditors, and small investors (meaning those with less than a $20,000 investment) are exempt from the MPL regime.

Financial Institutions Context

The prudential regulation and supervision of financial institutions is based on a reliance approach that emphasizes the role of the board of directors, management and independent advisers such as auditors and actuaries. The ability of the regulator or insurer to rely on independent advisers, and the reliability of the information they provide, is key to the approach of the regulator in maintaining the safety and soundness of the financial system, e.g.:

- auditors are relied upon to provide an objective opinion on whether the financial statements of the institution fairly present, in accordance with GAAP, its financial position;[6] and

- actuaries are relied upon to provide an objective view of the policy liabilities and prospective financial condition of insurance companies.

The current joint and several liability framework is intrinsic to this regulatory approach in that it strengthens the incentive for those responsible for the preparation of financial information to be attentive to their duties. Introducing an MPL regime could undermine this approach. To the extent that financial regulators are less able to rely on financial information, this may demand a much more intrusive supervisory system, which is not in keeping with the need for cost-effective regulation.

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[6] Note that auditors are also required to perform a number of duties that are unique to financial institutions (e.g. provide well-being report).

It is also important to note that the introduction of an MPL regime into the financial institutions legislation could require that the exemptions scheme in the CBCA be broadened to include a significant proportion of creditors (e.g. depositors, OSFI, the Canada Deposit Insurance Corporation). Introducing an MPL regime would create a separate, complex framework that would apply to a relatively small residual group of creditors, and would further complicate any insolvency situation.

The Department is not proposing that an MPL regime be introduced into the financial institutions legislation.

5. Directors' Residency

In the recent amendments to the CBCA, the directors' residency requirement was reduced for many companies from a majority to one-quarter. These changes did not apply, however, to companies that are subject to special ownership rules, such as telecommunications companies. For these types of companies, existing requirements were maintained (e.g. that 80% of the board be resident Canadians; or that a majority of the board be resident Canadians).

In consultations on reforms to the financial sector framework contained in Bill C-8,[7] certain financial institutions indicated that the requirement for three-quarters of the directors of a board of a financial institution to be resident Canadians did not allow sufficient scope for the composition of the board to reflect the international character of these institutions' operations.

In response to this concern, the government reduced the Canadian residency requirement from three-quarters to two-thirds in the Bill. This change achieved a balance between the competing objectives of allowing for increased flexibility for institutions, while at the same time continuing to ensure that the board has a meaningful Canadian presence.

The Department is of the view that the current two-thirds Canadian residency requirement is appropriate and is not proposing further changes to this threshold at this time.

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[7] Bill C-8, *An Act to establish the Financial Consumer Agency of Canada and to amend certain acts in relation to financial institutions*, came into force on October 24, 2001.

II. RIGHTS OF SHAREHOLDERS

Overview

The financial institutions legislation sets out the rights of shareholders to participate in the major decisions of a corporation in which they have an interest.

For shareholders to exercise these rights, they must have timely access to corporate information and be able to vote, in person or by proxy, at shareholders' meetings. The legislative provisions governing these matters are designed to help ensure that management decisions are in the best interests of the institution.

Proposals for Consultation

1. Proxy Solicitation

A shareholder's ability to discuss and monitor corporate performance in overseeing the management of an institution is an important element of good corporate governance. Facilitating the transmission of information among shareholders enhances their ability to carry out this function.

The proxy provisions are intended to achieve this objective by providing for the timely and accurate transmission of information among shareholders for the purpose of participating in the decision-making process. However, concerns have been raised that certain aspects of the current proxy rules relating to formal solicitation requirements are not always consistent with this objective in that they inhibit the informal communication of information between shareholders.

To address this concern, the CBCA was amended to provide more freedom for shareholders to communicate information with each other without triggering the proxy rules. For example, a number of forms of communications, such as public announcements, press releases, communications for the purposes of securing support for a proposal, and communications concerning the organization of a dissident proxy solicitation, were specifically exempted from the proxy solicitation requirements.

More detailed information on the specific changes introduced under the CBCA, including amendments relating to public solicitation of proxies and harmonization of proxy rules with provincial securities requirements, is provided in Annex A of this paper.

Proposal: To introduce similar changes to the proxy provisions in the financial institutions legislation.

2. Electronic Participation in Shareholder Meetings

For shareholders to exercise their corporate governance rights in an effective manner they must have timely access to corporate information and be prepared to vote at shareholder meetings. Legislative provisions designed to facilitate this process will help to ensure that management decisions are in the best interests of the institution.

The CBCA was amended to clarify the circumstances under which shareholders may participate and vote in shareholder meetings by telephone and other technological means. As well, new rules were added to clarify that participants in such meetings must be permitted to adequately communicate with each other through electronic means.

Proposal: To similarly clarify the financial institutions legislation to facilitate electronic participation in meetings. In moving forward with these proposals, the Department will be assessing the specific types of conditions that may be needed to accommodate these changes and how such changes should be implemented.

3. Shareholder Proposals

The corporate governance framework includes a number of measures to promote the ability of shareholders to influence the decision-making process of an institution. One of these provisions is the right of shareholders to make proposals to be considered at a shareholders' meeting.

A concern has been raised that certain technical aspects of the shareholder proposal rules should strike a more appropriate balance between the ability of shareholders to exercise their democratic governance rights, as against the cost implications for institutions and other shareholders of the institution in responding to these proposals.

A number of specific amendments were made to the CBCA to adjust the balance between these considerations. These changes include a reduction in the scope of authority for a company to reject a proposal by a shareholder and the addition of new threshold requirements (e.g. minimum periods in which shareholders must hold shares prior to making a proposal) to ensure that proposals can only be made by shareholders who have a long term interest in the financial viability of the company.

An overview of these changes, and their impact on the rights of shareholders, is set out in Annex A of this paper.

Proposal: To introduce similar changes to the shareholder proposal provisions in the financial institutions legislation.

4. Beneficial Shareholders

To facilitate ease of trading, large numbers of shareholders in companies, including financial institutions, hold their shares through brokers. These shareholders are referred to as beneficial, rather than registered, owners of the shares.

Under the current financial institutions framework, the rights of registered shareholders are clearly established, including the right to make proposals to be considered at a shareholders' meeting. However, the scope of the rights afforded to beneficial shareholders is not as clear.

Initiatives have been undertaken in other legislative and regulatory frameworks to clarify the rights of beneficial shareholders. For example, the CBCA has been amended to allow beneficial shareholders to make proposals. The Canadian Securities Administrators have introduced a rule that intermediaries must provide a list of the beneficial shareholders of a company to that company to facilitate the ability of the company to communicate directly with its beneficial shareholders.[8]

Proposal: To maintain an integrated and comprehensive legislative framework for financial institutions in respect of beneficial shareholders.

Within this framework, the proposal is to introduce changes in the financial institutions legislation similar to those made in the CBCA to clarify the rights of beneficial shareholders to make proposals.

The proposal is also to harmonize with the new requirements that have been introduced by the Canadian Securities Administrators, including, for example by amending the financial institutions legislation to require that intermediaries provide a list of the beneficial shareholders of a financial institution to that institution.

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[8] National Instrument 54-101 (came into force on June 14, 2002) imposes this requirement only where the company itself requests this information from the intermediary. Under the current financial institutions legislation, beneficial shareholders are entitled to receive relevant information only from registered shareholders.

III. MODERNIZING GOVERNANCE PRACTICES

Overview

Taking into account the importance of good corporate governance practices to the overall well-being of a financial institution, the financial institutions legislative framework needs to be kept up to date with best practices in this area.

Recent trends and developments in areas such as electronic communications can be used to enhance the ability of a financial institution to deliver on corporate governance commitments. Facilitating the transmission of information may not only enhance the effectiveness of corporate governance practices, but could also allow institutions to realize efficiencies and reduce costs in carrying out their obligations and responsibilities under the legislation.

It is also important for federal governance legislation to be consistent with best practices in other jurisdictions, including in areas such as corporate restructurings. Moreover, going forward, there is a need to ensure that federal rules are sufficiently flexible to allow for adjustments to be made to streamline and modernize the regime on a timely basis.

Proposals for Consultation

1. Electronic Communications

The Department is supportive of facilitating electronic communication of information required under the federal financial institutions legislation. Facilitating the timely and accurate transfer of information could promote more effective governance practices and procedures for institutions and their stakeholders. Moreover, by promoting a more efficient flow of information, compliance costs for the institution and its stakeholders could also be reduced.

A new part was added to the CBCA to provide a framework for the electronic transmission of information between a company and its shareholders and directors, etc. Amendments were also made to transfer to the Director of Corporations the authority to provide for the electronic transmission of information between companies and the government.

Proposal: To develop a comprehensive framework, similar to that introduced under the CBCA, to permit the electronic transfer of information under the financial institutions legislation. This would ensure that the financial institutions legislation continues to set out an integrated and transparent framework for the regulation of financial institutions.

In moving forward with these proposals, the Department is assessing the specific types of communications that could be facilitated, the types of conditions and terms that would need to be implemented to accommodate such changes, and how such changes should be implemented. A number of issues

are being assessed in this regard (e.g. consent requirements, security and confidentiality issues, technical readiness and whether different types of rules and procedures may be required to reflect the different types of information requirements under the legislation).

2. Going Private Transactions

A going private transaction ("GPT") is a general term that applies to a wide variety of corporate transactions that terminate the legal interest of a shareholder without the shareholder's consent, but with compensation.[9] These transactions involve a controlling shareholder "squeezing out" minority shareholders.

For CBCA companies, a number of provincial and federal legislative provisions have historically applied to these types of transactions. For example, provincial securities regimes contain provisions relating to the protection of minority shareholders in the event of a GPT. Matters such as valuations, fairness opinions, disclosure requirements and approval by a majority of minority shareholders are included in these provisions.

In addition, the CBCA has historically provided recourse to shareholders by allowing dissenting shareholders to use the "right of dissent" if they believe that they have not received fair value for their shares. As well, the CBCA also provides for a general "oppression remedy" that can be used by shareholders at any time.

Prior to the recent amendments to the CBCA, however, the legislation did not explicitly refer to GPTs. While the policy was to permit these transactions for CBCA companies (provided that provincial securities rules were followed), this was not clearly stated in the legislation. The recent amendments to the CBCA clarified the status of these transactions by enacting the policy in the legislation, i.e.:

- GPTs are permitted, provided that provincial securities rules are followed;
- for companies that are not subject to provincial securities rules, GPTs are permitted, but only if a majority of the minority shareholders approve.

The financial institutions legislation is silent on GPTs and, unlike the CBCA, does not include an "oppression remedy" or "right of dissent". This means that shareholders in a financial institution undergoing a GPT are guided only by provincial securities rules. While Ministerial approval may be required for certain GPTs (e.g. amalgamations), there may be certain GPTs that would not necessarily trigger such a requirement (e.g. share consolidation).

Proposal: To amend the financial institutions legislation to clarify the status of GPTs. This could be accomplished by requiring Ministerial approval (unless otherwise required) and an approval of a majority of the minority for these transactions.

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[9] Not including a transaction where the shareholder's legal interest is terminated in exchange for another participating security.

An alternative option that could also be considered would be to create in the financial institutions legislation a more comprehensive framework for GPTs that would include many of the key requirements set out under provincial rules in this area (e.g. valuations, fairness opinions, disclosure requirements, and approval by a majority of minority shareholders).

3. Harmonization/Streamlining

The federal financial institutions legislation sets out an integrated and comprehensive legislative framework for the regulation of federal financial institutions. This framework includes rules on matters such as proxies, prospectuses and insider trading and reporting.

Provincial governments, however, also set rules in these areas, and these rules have implications for federal financial institutions. In cases where there is consistency in policy objectives between the federal and provincial rules in a particular area, duplication and overlap of these rules should be minimized.

A more detailed description of the types of proposals being considered to harmonize and streamline rules is provided in Annex A of this paper.

Proposal: To maintain an integrated and comprehensive legislative framework for financial institutions in areas such as proxies, prospectuses, and insider trading and reporting. To minimize concerns relating to duplication and overlap, the proposal is to review federal rules to identify areas where adjustments can be made to promote further harmonization with provincial requirements.[10]

As described in more detail in Annex A of this paper, the proposal, subject to one key exception, is to amend the financial institutions legislation to reflect most of the technical changes made to the CBCA in a number of the above noted areas, including insider trading.

The key exception is in the area of speculative trading. More specifically, the Department is not proposing to adopt the CBCA amendment to permit insiders to invest in calls or puts of a institution for the purpose of speculating on increases in the price of an institution's securities.

The Department's concern is that this proposal would be inappropriate in the context of financial institutions, as it could create increased opportunities for insiders to take risks to manipulate the short-term stock price of a financial institution.

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[10] The Department is assessing specific areas where possible changes could be made, including providing exemptions from federal requirements in cases where there is a consistency between the policy objectives between federal and provincial rules in particular area.

4. Transfer of Technical Requirements from Legislation to Regulations

A number of technical governance requirements are set out in the legislation. Similar types of detailed requirements are also set out in other parts of the legislation (e.g. exemption for small holdings in the ownership rules).

Concerns have been raised, particularly in terms of the governance regime, that the federal legislation needs to be kept up to date with modern practices and developments in other jurisdictions.

Providing flexibility to make adjustments to the governance rules through regulations, rather than by mandating legislative changes, would facilitate the ability of the government to respond more rapidly to changes in best practices. The CBCA was amended to allow this to occur. A brief overview of the changes made to the CBCA in this regard is provided in Annex A of this paper.

Proposal: To move certain technical requirements in the governance provisions of the legislation (e.g. dollar amounts and time limits) to the regulations.

CHAPTER 3
GOVERNANCE PROVISIONS FOR POLICYHOLDERS

INTRODUCTION

This chapter focuses on assessing measures designed to modernize the corporate governance provisions applicable to certain policyholders.

Policyholder governance provisions reflect the unique interests and role of certain policyholders in corporate governance under the ICA. These include holders of participating ("par") policies, who are entitled to participate in the profits of a company by receiving dividends. In turn, under the ICA, they have rights to participate in the governance of the company, including rights to vote, make proposals and elect directors. Companies issuing par policies must also meet certain requirements with respect to the par account. In practice, only life insurance companies, both mutual and stock, issue par policies.

In addition, an insurance company may grant non-par policyholders the right to vote through its incorporating instrument or the by-laws of the company. In cases where a company does so, the ICA confers upon such policyholders the same rights as par policyholders in respect of voting, making proposals and electing directors. In practice, only mutual property and casualty (P&C) insurance companies currently issue voting non-par policies.

The proposals in this chapter include:

- scaling back policyholders' "general political" rights in stock companies;
- enhancing the protection of participating accounts in stock companies through disclosure and greater accountability to ensure that policyholders' reasonable expectations are met; and
- giving to policyholders of mutual companies governance rights closer to those of shareholders in stock companies.

This review will also consider whether the governance framework for insurance companies should include measures to reflect the interests of holders of adjustable policies.

The chapter is divided into the following subject areas: direct participation of policyholders in governance, participation of policyholders' directors, and par accounts and adjustable policies.

I. DIRECT PARTICIPATION OF POLICYHOLDERS

Overview

Voting policyholders have rights to participate directly in the governance of insurance companies, whether they are mutual or stock companies. Specifically, each voting policyholder is entitled to exercise one vote, attend meetings, receive notices of meetings, and request special meetings. Voting policyholders may also have proposals on specific matters of interest circulated in advance of an annual meeting, subject to certain rules. The legislative proposals that follow seek to streamline and enhance these direct participation rights of policyholders.

Proposals for Consultation

1. Right of Policyholders to Vote in Mutual P&C Companies

Some federally-regulated mutual property and casualty (P&C) companies have a very small voting base because they sell very few policies that entitle their holders to vote. In contrast, voting policies, particularly par policies, are prevalent in mutual life companies for historical and economic reasons.

A narrow voting base may reduce the effectiveness and fairness of governance because the management of such companies is accountable to only a few policyholders. Moreover, one of the objectives of a mutual structure is to allocate the risks and benefits of ownership to a broad group of people. As a consequence, it may be advantageous to increase the voting base of policyholders in mutual insurance companies in the P&C sector.

Proposal: To extend the right to vote to all policyholders of P&C mutual companies, subject to certain exclusions (e.g. policies of short duration or that fall below a certain premium value). One practical approach would be to extend the right to vote to policyholders upon purchase of a policy or renewal of an existing policy.

2. Policyholders' Proposals in Mutual Companies

a) Number of Signatures Required for Circulation

At present, the signatures of at least 100 voting policyholders are required for any policyholder proposal to be circulated (i.e., the lesser of 250 or 1% of policyholders entitled to vote for director nominations, the lesser of 500 or 1% of policyholders entitled to vote for a proposal on certain substantial changes, and 100 voting policyholders for all other proposals).

The right to make proposals and have them circulated before a meeting is an important mechanism to allow voting policyholders in mutual companies to raise issues of interest to them regarding the companies they own. Yet, it is not clear that this right is exercisable in practice. The number of required signatures may be too high.

Making the list of voting policyholders available to a policyholder wishing to circulate a proposal would facilitate gathering the required signatures. However, given the commercial importance of such lists, the ICA does not require making them available to voting policyholders.

Proposal: To reduce the number of signatures required for the nomination of directors to the lesser of 50 and 1%, and the number for proposals regarding substantial changes to the lesser of 100 and 1%. For all other proposals in mutual companies, only one policyholder signature would be required for circulation.

b) Circulation of Proposals on Ordinary Affairs or a Change of Corporate Direction

A company can refuse to circulate a policyholder proposal that relates to the management of ordinary business and affairs of the company. In addition, it can refuse to circulate a policyholder proposal that would, if implemented, result in a change in the character or direction of the company that would have a material adverse effect on the ability of the company to meet the reasonable expectations of the company's par policyholders as to the net cost of their insurance. In contrast, there is no restriction on shareholders in stock companies making such proposals.

The discretion to refuse the circulation of such policyholder proposals appears to be inappropriate. In addition, voting policyholders, as the owners of mutual companies, should have similar rights as shareholders in stock companies to make such proposals.

Proposal: To repeal these constraints on the rights of voting policyholders in mutual companies to have such proposals circulated.

3. Policyholder Votes and Proposals in Stock Companies

Under the ICA, policyholders entitled to vote in stock companies (i.e., mostly par policyholders in life insurance companies) vote with shareholders, except in respect of fundamental changes and the election of policyholders' directors, which both involve separate voting.

In practice, when the votes of shareholders and policyholders are counted together, par policyholders' votes represent a very small portion of total votes in a stock company, which reduces the significance of par policyholders' votes. More importantly, the rights of par policyholders to make proposals and vote on the general affairs of stock companies may be disproportionate to their corporate interests.

It can be argued that par policyholders' interests in stock companies could be better protected by specific measures relating to the management of par accounts and dividend policies, instead of extensive rights to vote and make proposals. These measures are addressed in part III of this chapter.

Proposal: To limit the voting rights of voting policyholders in stock companies to the election of policyholders' directors, the approval of fundamental changes and other matters related to the exercise of these rights (e.g., approval of a by-law establishing the quorum for policyholders' meetings).

The proposal is also to limit the rights of such policyholders to make proposals in stock companies to the nomination of policyholders' directors, with the number of signatures of voting policyholders required to have such a proposal circulated reduced to the lesser of 50 and 1% (as outlined for mutual companies previously).

4. Form of Proxies

The ICA requires insurance companies to solicit proxies from all shareholders and policyholders entitled to receive notices of meetings. There are currently no regulations under the ICA prescribing the form of proxy that must be provided to policyholders entitled to vote.

As a consequence, policyholders may not necessarily receive a form of proxy permitting them to indicate how their vote must be exercised on each individual matter on which they are entitled to vote and that will be considered at a meeting. It can be argued that requiring proxies to be in a form to allow voting policyholders to exercise their vote on each individual matter would promote more direct participation of voting policyholders in insurance companies.

Proposal: To introduce regulations to prescribe such a form of proxy. The Department is assessing whether it would be appropriate to harmonize such requirements with provincial securities rules, including providing exemptions where insurance companies treat policyholders as though they are shareholders for the purposes of the form of proxy rules.

5. Request for Special Meeting

The ICA permits 500 policyholders entitled to vote or 1% of all such policyholders of a company, whichever is greater, to request directors to call a special meeting. In a stock company, shareholders with at least 5% of the shares may make a similar request.

This threshold for policyholders may make this right difficult to exercise in practice given that the list of policyholders is not available to policyholders and the holder of one or more policies is entitled to only one vote. A strong case can be made that the threshold should be lowered for voting policyholders in a mutual company, since they are the owners of the company. With respect to voting policyholders in stock companies, this right may exceed their corporate interests and be unnecessary in light of the proposals relating to par accounts in part III of this chapter.

Proposal: To repeal the provisions giving voting policyholders of stock companies the right to request a special meeting, and to reduce the number of policyholders' signatures required to call a special meeting in a mutual company to the lesser of 200 and 1% of policyholders entitled to vote.

6. Notices of Meetings

Under the ICA, companies must send notices of meetings to voting policyholders. Companies may choose between two practices in this regard. They can send notices to all policyholders entitled to vote or only to those who have indicated an interest in receiving notices. In the latter case, the company must, at least every three years, ask all policyholders entitled to vote whether they want to receive notices of meetings in the future. To qualify to receive such notices, policyholders must return a card provided by the company.

Even for companies that elect the second practice, canvassing all policyholders entitled to vote every three years can be costly. It may be unnecessary in that many policyholders do not change their decisions regarding notices from one period to the next. At the same time, a case may be made that the current rules are overly rigid for policyholders who wish to change their decision within each three-year period.

Proposal: To provide greater flexibility to policyholders and insurance companies, the proposal is to require companies to canvass their policyholders regarding receipt of notices every five years, but permit policyholders to notify the company at any time within each five-year interval of their interest in receiving notices in the future. In addition, the Department is assessing possible ways to facilitate responses to notices (e.g., postage paid mail replies, telephone replies, electronic forms of communication).

ii. Participation of policyholders' directors

Overview

Under the ICA, voting policyholders in stock companies have the right to elect at least one third of the board of directors. These directors elected by policyholders are called policyholders' directors. As the only voting policyholders in stock companies are life insurance policyholders, this right to elect directors in stock companies is limited in practice to the life insurance sector.

This part of the paper focuses on matters relating to policyholders' directors, including their number and eligibility for the position.

Proposals for Consultation

1. Number of Policyholders' Directors

The representation of voting policyholders on the boards of stock companies through the election of policyholders' directors was originally intended to protect policyholders' interests in participating in the company's profits.

Given the trend of declining sales of par policies in recent years and the proposals related to par accounts (part III of this chapter), it may be appropriate to reconsider the current level of representation. It can be argued that the right to elect at least one third of directors is too high relative to the economic interests of par policyholders in stock companies today.

Proposal: To reduce the minimum number of policyholders' directors in a stock company from one third of the board to the lesser of one third and four directors.

It could also be argued that the requirement for policyholders' directors should be eliminated altogether. At the time of demutualization, it was decided to continue with the traditional approach based on participating policyholders' input into the selection of individuals on the boards of stock companies rather than moving towards alternative mechanisms, such as increased regulatory oversight. The Department does not intend to change the basic approach of giving participating policyholders input into the composition of the board at this time.

2. Qualification of Policyholders' Directors

Under the ICA, policyholders' directors are prohibited from holding shares in the company on whose board they serve. There is, however, no prohibition on policyholders' directors holding shares in the company's parent, which could allow policyholders' directors to have an indirect shareholder's interest in the insurance company.

It can be argued that policyholders' directors holding shares in an entity controlling a company on whose board they serve may lead to conflicts of interests vis-à-vis the policyholders who elect them. On the other hand, it can also be argued that it is inappropriate to impose restrictions on the remuneration of policyholders' directors if all directors have the duty to act honestly and in good faith with a view to the best interests of the company. It would be appropriate for the ICA to have a consistent approach toward the ownership of shares by policyholders' directors at the operating company and holding company levels.

The Department is assessing two options. One option is to prohibit policyholders' directors from holding shares in an entity controlling a company on whose board they serve. Another option is to abolish the restriction on policyholders' directors holding shares of a company.

3. Policyholders' Affairs Committee

At present, the ICA does not require a board with policyholders' directors to adopt any particular structures for the specific purpose of considering policyholder interests. While maintaining a company's flexibility to manage its own affairs internally, it may be appropriate to give directors a more formal role in reviewing the company's compliance with requirements under the ICA affecting par policyholders.

Proposal: To require each stock insurance company with par policyholders to form a policyholders' affairs committee. Its general mandate would be to assist the board in serving the corporate interests of par policyholders. The Department is assessing the appropriate composition of the committee.

III. PAR ACCOUNTS AND ADJUSTABLE POLICIES

Overview

The ICA requires companies to maintain separate accounts in respect of par policies. Expenses and income are to be allocated to these accounts according to methods approved by the board, after considering the written opinion of the actuary of the company that the methods are fair and equitable to the participating policyholders. The actuary of the company must also report annually on the fairness and equitableness of the methods.

The company pays dividends to par policyholders out of the par accounts. Under the ICA, the directors of a company are required to establish a dividend policy and the actuary of the company must report that the proposed dividends are in accordance with the policy.

This part reviews the rules relating to par accounts to help ensure that par policyholders' rights to participate in the profits of an insurance company are respected. It also proposes some governance measures in respect of adjustable policies where adjustments have effects on policyholders similar to the declaration of dividends on par policies.

Proposals for Consultation

1. Par Accounts in Mutual Companies

The ICA requirement for companies issuing par policies to maintain separate par accounts is designed to promote transparent accounting and thereby support par policyholders' rights to participate in the profits of the company. However, it may be unnecessary to apply this requirement in mutual companies, given that voting policyholders (mostly par policyholders) wholly own them. As the owners, the interests of par policyholders of mutual companies extend beyond the par account to all activities of the company. Therefore, an argument can be made that the appropriate instruments to ensure accountability of the board to par policyholders in mutual companies are the general financial statements of the company.

Proposal: To abolish the requirement to maintain par accounts in mutual insurance companies. However, measures respecting disclosure of dividend policies and annual dividends would continue to apply to all mutual companies with participating policies.

2. Management of Par Accounts

As noted earlier, insurance companies issuing par policies must maintain a separate par account. However, the only information the ICA requires companies to disclose on the management of the account is information relating to changes for a financial year in a participating account. An argument may be made that management accountability in

respect of the par account would be enhanced if policyholders were provided with more information on the management of the account. This would give policyholders greater insight into the impact of the corporate decisions regarding the par account.

The surplus in the par account (i.e. the undistributed net earnings of the account) is one area where disclosure might be improved. A decision by a company to retain surpluses in its par account instead of paying higher dividends may, over time, lead to significant accumulated surpluses that could create inequities among different generations of par policyholders. This is particularly likely where a company with a growing surplus sells fewer and fewer par policies. Increased transparency might raise awareness of the issue of large accumulated surpluses.

Proposal: To require companies to provide their par policyholders annually with more information about the management of par accounts, such as:

- ***a) the form of the par account;***
- ***b) the income and expenses allocated to the account, on an annual basis;***
- ***c) the historical ratio of the surplus in the account over par policy liabilities;***
- ***d) the performance of the par account; and***
- ***e) the proportion of the yearly net earnings of the account being distributed to par policyholders and shareholders.***

The details would be set out in regulations.

3. Seed Money

The ICA generally limits the amount of profits that can be transferred from a participating account to shareholders according to a fixed formula. In addition, transfers from a participating account may be made in respect of transfers or reinsurance of participating policies and, with the approval of the Superintendent, in respect of amounts that can reasonably be attributed to sources not related to the participating policies.

In some circumstances, the ICA also permits mutual and stock insurance companies to use the par account to provide seed money for segregated funds[11]. As shareholders earn profits on segregated funds, such transfers from the par account may effectively provide a direct source of profits for shareholders. This may be inappropriate given the general limits on transfers and the fact that stock companies have other sources of seed money, such as share capital or non-par profits.

The Department is assessing whether it would be appropriate to prohibit stock companies from using par funds as seed money for segregated funds.

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[11] In a segregated fund, the liabilities of the company in respect of the policies or the amounts accepted or retained vary depending on the market value of a specified group of assets.

4. Duty of Directors Regarding the Par Account

The ICA does not explicitly require directors to consider the interests of par policyholders in the administration and general management of the par account, including allocating income and expenses to the account, and declaring dividends and transferring sums from the account. However, a case can be made that accountability of the company to par policyholders' corporate interests could be furthered by assigning an explicit duty on directors with respect to the par account.

The Department has developed two options for discussion. One option is to explicitly require directors of stock insurance companies to consider the interests of par policyholders when fulfilling their functions in relation to the par account.

Another possibility is to specify that directors of stock companies must act in a manner that is fair and equitable to par policyholders in respect of the par account.

Consideration must be given to what recourse if any should be available in respect of this duty. In addition, an assessment of these options must take into account the general duty on directors to act honestly and in good faith with a view to the best interests of the company under the ICA. If a special duty were added to the general duty to the company, it may be necessary to consider how directors would reconcile these two duties. In the case of Australia, this was accomplished by requiring directors to give priority to the interests of policyholders when they conflict with those of shareholders.

5. Policy Dividends

There is a legislative requirement for companies that issue par policies to include with their annual statements a summary of the policy established for determining the dividends to be paid to par policyholders. The policy intent was that the summaries of dividend policies should allow policyholders to compare the dividend policies of different companies.

At present, there is no requirement for disclosure of specific information in the summaries of dividend policies. It can be argued that improved disclosure in the summaries of dividend policies might permit par policyholders to better see how different companies would meet their reasonable expectations as to the net cost of their insurance.

Proposal: To prescribe specific information to be disclosed to par policyholders in the required dividend policy summaries. This would include the principles, factors and practices that the companies take into account in determining dividends, such as the general level of annual net earnings that would normally be allocated as dividends and the basis used for the allocation of dividends among classes of policies. The details would be set out in regulations.

In addition, the proposal is also to require a statement on the fairness of the proposed scale of dividends in the actuary's annual report to the board.

6. Adjustable Policies

As noted earlier, some life insurance policies can be long-term, non-participating, and at the same time have premiums (or other values of the policy, e.g., face amount or cash surrender value) that are not guaranteed in the contract but left to the discretion of the company to determine from time to time. For example, the pricing structure may change prospectively based upon revised estimates of economic or demographic events. The existing corporate governance provisions in the ICA do not provide a framework for the exercise of the discretion of companies relating to adjustable policies.

It can be argued that holders of such adjustable policies have an economic interest in the governance of insurance companies resembling that of par policyholders. In both cases, the company retains a discretionary right that can affect the costs or benefits of the policy to the policyholder. However, holders of adjustable policies do not have the same corporate rights as par policyholders.

The Department has developed options for discussion to mandate specific corporate governance requirements in respect of adjustable policies:

a) ***directors could be required to approve adjustments to adjustable policies and consider the interests of the holders of adjustable policies in so doing;***
b) ***directors could be required to act fairly and equitably respecting adjustments to adjustable policies;***
c) ***the actuary of the company could be required to report to the board on whether proposed adjustments are fair and equitable to the holders of the adjustable policies;***
d) ***companies could be required to disclose annually all adjustments to such policies and provide information on the criteria, if any, used to make adjustments (the details would be set out in regulations); and***
e) ***the policyholders' affairs committee's mandate could include assisting the board in fulfilling its responsibilities in respect of adjustable policies.***

Given their shared objective, assessment of these options must take into account the relative costs and benefits of each option or group of options. With regard to the duties of directors in respect of adjustable policies (items a) and b)), consideration must be given to harmonization with the general duty to act in the best interest of the company and to enforcement.

ANNEX A
Details on Chapter 2 Proposals

OVERVIEW

This Annex provides further detail on a number of proposals that relate to the broader policy proposals discussed in Chapter 2 of this paper.

The proposals in this Annex are generally described in terms of the changes made to the CBCA. Unless otherwise indicated, the following considerations apply:

- **the financial institutions legislation is similar to the corresponding CBCA provision; and**
- **the Department is considering proposing similar changes to the financial institutions legislation.**

I. DIRECTORS AND OFFICERS

1. Indemnification

The CBCA was amended to clarify and expand the legislative provisions relating to the ability of a company to pay indemnification. Under the new rules, companies are permitted to:

- pay defence costs in respect of **investigative proceedings**;
- advance funds **before** the conclusion of a proceeding; and
- pay the costs of a person on the board of another company, even where the company paying the indemnification **holds no shares or debt in the other company**[12].

The areas where clarification has been provided include the following:

- indemnification is not **mandatory**[13] in derivative actions (e.g. where shareholders or others initiate a legal action on behalf of the company); and

[12] The company may indemnify a director who is acting as a director of the other company at the request of the indemnifying company.

[13] The indemnification must instead be court approved.

- the requirement that a person must be "successful on the merits" to claim indemnification for costs was changed to permit indemnification so long as the person is not found to have **committed any fault or omitted to do anything that the person ought to have done**.

The CBCA was also amended to allow companies to purchase insurance for directors against liabilities relating to their failure to act honestly and in good faith with a view to the best interests of the company. The Department is assessing whether it is appropriate to adopt this particular indemnification proposal in a financial institutions context.

2. Conflicts of Interest

The CBCA was amended to expand and clarify the conflict of interest rules.

The key areas of expansion include the following:

- rules extended to apply to **transactions**;
- directors are now required to bring **material changes** in the nature of their interest to the attention of the board of directors;
- shareholders are entitled to gain **access to the minutes of meetings that relate to conflicts of interest**; and
- a court is expressly authorized to require accounting for profits in respect of a breach of **any** of the conflict of interest rules.

The key areas of clarification include:

- provisions relating to the requirement for disclosure to be made **at the time of the meeting**;
- a prohibition on interested directors **voting** on contracts or transactions; and
- adjustments to the rules setting out the circumstances under which directors will not be required to **account for profits** (e.g. clarification on approval requirements).

II. SHAREHOLDERS

1. Proxies

The CBCA was amended to ease the constraints on the ability of shareholders to communicate information with each other without triggering the proxy rules. Amendments were also made to harmonize the proxy rules in the CBCA with provincial requirements in this area.

The amendments led to an easing in the constraints on the communication of information for the following:

- new exemptions from the proxy solicitation requirements for the following forms of communications:
  - public announcements of how a person intends to vote in a speech in a public forum;
  - press releases, opinions, statements or advertisements provided through broadcast media telecasts or generally available publications;
  - communications for the purposes of securing the needed support for a shareholder proposal (pooling);
  - certain communications among shareholders concerning the business and affairs of the corporation (if no form of proxy is sent by the shareholder(s) making the communication);
  - certain communications among shareholders concerning the organization of a dissident (i.e., non-management) proxy solicitation (if no form of proxy is sent by the shareholder(s) making the communication);
  - communications to shareholders by a person engaged in the business of providing proxy-voting advice; and
  - communications by a person who does not seek, directly or indirectly, the power to act as proxy for a shareholder;
- new flexibility to allow registered shareholders to appoint a proxy, provided that if the shares are owned by a beneficial shareholder, the beneficial shareholder consents;[14]
- new exemption from the proxy circular requirements to allow a person, other than management of the company, to solicit proxies without sending a dissident's proxy circular if the solicitation is, in the

[14] The rules also clarified that if the beneficial owner gives voting instructions to the intermediary, they must be in writing.

prescribed circumstances, conveyed by public broadcast, speech or publication.

- new exemption from the proxy circular requirements to allow a person, other than management of the company, to solicit proxies without sending a dissident's proxy circular if the total number of shareholders solicited is 15 or fewer.

The amendments to harmonize with provincial rules were as follows:

- application of the mandatory management proxy solicitation rules to all **distributing** companies (previously companies with 5 or fewer shareholders were not subject to these requirements); and

- relief from the mandatory management proxy solicitation rules for **non-distributing** companies with **50** shareholders or fewer (only companies with fewer than **15** shareholders were previously relieved from these requirements); and

- replacement of the term "registrant" with "intermediary".

2. Shareholder Proposals

The amendments to the CBCA in this area fall into three general categories:

- easing of constraints on the ability of shareholders to have their proposals voted on at a shareholders' meeting;

- addition of new rules to require that shareholders have a genuine interest in the company before making a proposal; and

- adjustments to certain of the administrative requirements relating to proposals.

To ease the constraints on the ability of shareholders to make proposals, the CBCA was amended to adjust the substantive criteria that can be utilized by a company to reject a proposal:

- the current set of relatively broad criteria (e.g. proposal is primarily for the purposes of promoting general economic, political, or similar causes) was narrowed, and a new criterion (i.e. that it clearly appears that the proposal does not **relate in a significant way to the business or affairs of the company)** was introduced.

To ensure that shareholders have a genuine interest in the company before making a proposal, the following changes were introduced:

- the shareholder must own at least **1% of the shares** or **$2000 worth of shares of the company**;

- the shareholder must have held the shares for at least **6 months**; and
- the shareholder must hold the shares from the date of the proposal to the **date of the meeting**.

The amendments to the administrative requirements relating to proposals included the following:

- the deadline to submit a proposal was advanced from 90 days before the anniversary date of the last annual general meeting to **90 days before the anniversary date of the notice of meeting of the last annual general meeting**; and
- a limit of **500 words** was imposed on the combined size of a **proposal and supporting statement**.[15]

III. Modernization

1. Harmonization/Streamlining

Several of the insider trading provisions of the CBCA were amended to expand and clarify the rules in this area:

- expansion of the **definition of "insider"**[16] to cover a broader range of persons, including directors and officers of affiliate corporations and persons who engage in activities on behalf of the company;
- expansion of the insider trading rules to apply not only to securities that are related to the transaction, but to **any security** of the company;
- elimination of the requirement for an injured party to demonstrate any of the following in order to successfully sue an insider:
  - that the insider **benefited** from the insider trading activity;
  - that the insider made use of **specific** insider information for the insider's benefit or advantage; and
- addition of a new rule which makes an insider liable for losses of a **third party** who buys or sells securities from a person who has received material confidential information (i.e. a "tip") from the insider.

The CBCA was also amended to increase the specific sanctions imposed for insider trading to the greater of $1 million and three times the monetary gain.

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[15] Under the previous rules, supporting statements were limited to 200 words, while no limits were imposed on the size of a proposal.

[16] Definition is for the purposes of the civil liability regime under the CBCA.

While the Department is proposing that consideration be given to each of the above noted changes, in terms of sanctions, the Department's specific proposal is that the general sanction provisions in the financial institutions legislation be amended as follows:

- ***to increase the maximum fine that a court can order on monetary gains from an amount equal to the gain to an amount that is three times the gain; and***

- ***to increase the maximum penalty that may be imposed for indictable offences from $500,000 to $1 million for natural persons.***[17]

2. Legislation to Regulations

The CBCA was amended to provide authority for a number of requirements that are currently set out in the legislation to be moved to the regulations, including time limits on the following:

- fixing record dates for meetings;

- notice of meetings;

- notice of refusal of a proposal (e.g. when a company must notify that a proposal has been refused on grounds); and

- time periods on when proposals may be re-submitted.

[17] For entities, the maximum penalty for an indictable offence is $5 million.

Annex B
Other Technical Amendments*

OVERVIEW

Annex B provides a more detailed description of the other technical proposals the Department is considering with respect to the corporate governance provisions of the financial institutions legislation.

I. DIRECTORS AND OFFICERS

Subject: Definition of "officer"

Amendment: Broaden the definition of officer in the financial institutions legislation to mirror the new CBCA definition.

The Department is assessing the appropriateness of this proposal.

Explanation: The amendments to the CBCA introduced a definition of officer, which includes not only individuals appointed as officers, but also any other individual who performs functions for a corporation similar to those normally performed by an individual occupying any of those offices.

The general financial institution definition of officer currently includes designated officers, but does not include any other individual who performs similar functions. Certain other provisions, however, currently refer to persons performing similar functions. The proposal to amend the general definition will need to be assessed in terms of the implications for other uses of the term in the respective statutes.

Subject: Evidence of resolution

Amendment: Amends the provision to specify that an entry in the minutes of a meeting to the effect that the chairperson declared that a resolution is adopted or rejected is evidence of this decision, without it being necessary to prove the number of votes for or against the resolution.

Explanation: This change would increase flexibility and ease of record keeping.

* Note that changes in this Annex generally relate to similar changes made to the CBCA under Bill S-11. Exceptions to this rule (i.e. technical changes that only relate to the financial institutions legislation are marked with an asterisk).

Subject: Civil law concept of liability

Amendment: Change "jointly and severally liable" to "jointly and severally, or solidarily, liable".

Explanation: The addition of the words "or solidarily" would update the law to include the civil law concept of apportioning liability. This amendment would not change the substantive meaning of the current provision.

Subject: Consent to be a director

Amendment: Add a new subsection providing that an individual who is elected or appointed as a director is not actually a director unless he or she:

- was present at the meeting and did not refuse; or
- was not present at the meeting and consented in writing before the election or appointment or within ten days after; or
- has acted as a director subsequently.

Explanation: Currently under financial institution legislation, there is no prohibition on electing or appointing an individual as a director without his/her consent or knowledge. Someone elected or appointed as a director without his/her consent or knowledge could be exposed to extensive liability as a director.

This amendment would also harmonize financial institutions legislation with the CBCA and provincial corporate governance legislation.

Subject: Delegation of directors' powers – Appointment of additional directors

Amendment: Add a prohibition against delegation of the power to appoint additional directors.

Explanation: This amendment clarifies that the board cannot delegate the authority to appoint additional directors.

Subject: Delegation of directors' powers – Issuing series of shares

Amendment: Add new provision to allow delegation of the power to issue shares of a series as authorized by the directors.

Explanation: This amendment would ensure that the board may delegate the power to issue a series of shares only as authorized by the directors.

Subject: Delegation of directors' powers – Issuing securities

Amendment: Remove the references to the manner and terms under which this power may be delegated to allow for delegation of the power as authorized by the directors.

Explanation: Removing the references to the manner and terms for issuing securities would allow directors to set broader limits within which the delegation authority can be exercised. The change would increase directors' flexibility to delegate the power to issue securities.

Subject: Delegation of directors' powers – Payment of commissions

Amendment: Amend the current prohibition against delegation of the power to pay a commission for a sale of shares to make an exception that allows delegation as authorized by the directors.

Explanation: The change would increase directors' flexibility and allow them to delegate, within the limits that they set, the power to pay commissions for sales of shares.

Subject: Board of Directors*

Amendment: Clarify whether the residency requirement for the board of directors is a continuing requirement.

Explanation: Currently it is unclear whether the residency requirement for the board of directors must only be met at the time a director is elected, appointed, or at an annual meeting, or whether it is a continuing requirement that must be met at all times.

II. SHAREHOLDERS

Subject: Definition of Distributing Financial Institution

Amendment: Add a definition of distributing financial institution.

Explanation: Several aspects of the governance regime in the CBCA distinguish between public (distributing) companies and private (non-distributing) companies. In many cases, these provisions were developed with a view to harmonizing with provincial requirements in a respective area. In developing a new definition of a "distributing financial institution", consideration will be given to similar definitions currently under the financial institutions legislation, as well as provincial definitions in this area.

Subject: Access to central securities register

Amendment: Clarify that an affidavit is required before access to the securities register of a distributing financial institution is authorized and allow a reasonable fee to be charged for extracts. The affidavit shall state that the information will not be used except as permitted.

Explanation: An affidavit is currently required in order to obtain a shareholders list, but may not be required in order to obtain access to the securities register. This is somewhat of an anomaly given that more information is available from the securities register (e.g., information for all securities, not just shares, and past owners as well as present, and particulars of securities transfers including dates and the consideration).

Subject: Shareholder Meetings – Notice of Meeting

Amendment: Add a new provision that would permit a non-distributing financial institution to send out a notice of meeting within a shorter period before the meeting (e.g. less than the 21 days currently required), if specified in the by-laws.

Explanation: This change would provide flexibility for non-distributing financial institutions.

Subject: Shareholder Meetings – Extension of Time Period by Court

Amendment: Provide that financial institutions may apply to the court for an order extending the time period within which their annual meeting must be held.

Explanation: This amendment would provide increased flexibility. It would provide a means whereby financial institutions could receive an extension if they did not meet the time limits set out in the legislation. An applicant to the court would be required to give notice to the Superintendent, who would be able to appear at the hearing in person or by counsel.

Subject: Ability for Members of a Cooperative Credit Association to Vote through Mail-in Ballots.*

Amendment: Add a provision in the CCAA to allow members to vote on items at membership meetings through mail-in ballots.

The Department is assessing the appropriateness of this model.

Explanation: The CCAA does not allow members to vote their shares at membership meetings through proxies since this runs counter to cooperative principles. Mail-in ballots would allow members who are not otherwise able to attend meetings to still participate in membership decisions. This approach is consistent with cooperative principles since individual members would be voting their own shares. However, the implications of this amendment on some of the other legislative matters dealing with conduct of meetings (e.g., how a "by hands" vote at a meeting would work with mail-in ballots) are not clear.

III. MODERNIZATION

Subject: Specificity in Location of Registered Office

Amendment: This amendment changes the references in the financial institutions legislation from the "place" of the head office to the "province" of the head office.

Explanation: Allows a financial institution to change the location of its head office with greater ease, so long as it does not change the province in which the head office is located.

Subject: Corporate Seal

Amendments: This amendment provides that a corporation may, but need not, have a corporate seal.

Explanation: This change would clarify that corporate governance law does not require financial institutions to have or use corporate seals.

Subject: Compelled Acquisitions

Amendment: If a shareholder has recently acquired 90 per cent or more of the shares of a financial institution via a takeover bid, this amendment would allow the remaining minority shareholders to force the majority owner to acquire the minority's shares on the same terms as were offered to other shareholders in the takeover bid.

Explanation: If a single person owns 90 per cent of the shares of a financial institution, it is likely that the remaining shares will be illiquid and thinly traded. This provision allows shareholders who were unaware of the takeover bid, or those that did not tender their shares, to sell their shares.

Subject: Compulsory Acquisitions

Amendment: Require a financial institution that is repurchasing its own shares using the compulsory takeover provision to hold the payments to dissenting offerees in trust.

Explanation: Currently, financial institutions hold the offeror's payments to the dissenting offerees until a court determines fair value. This change ensures that where the financial institution is also the offeror (an issuer bid), the payments would be held in trust rather than by the financial institution.

Subject: Replacement of Auditors

Amendment: This amendment provides that if an auditor is replaced, the financial institution is required to make a statement on the reasons for the replacement, and the new auditor may make a statement commenting on these reasons. Both of these statements would be required to be sent to shareholders.

Explanation: The proposed changes require that the financial institution inform shareholders of the reasons for the replacement.

Subject: Subsidiaries Holding Shares of Parent*

Amended Regulation: Amend the existing regulation to allow a subsidiary of a financial institution to hold shares of its parent during the course of a restructuring that involves the creation of a holding company, subject to certain terms and conditions (e.g. temporary holding; regulatory approval required for the restructuring).

The Department is seeking comments on this proposal. The Department is also seeking comments on whether the exception should be extended to apply to other types of restructuring transactions permitted under the legislation.

Explanation: Under a corporate reorganization that involves the creation of a holding company framework, a subsidiary of a financial institution may hold shares in its parent for a brief moment in time (i.e. during a share exchange). The amended regulation would clarify that an exception to the legislative prohibition on a subsidiary holding shares of its parent would be permitted for such a restructuring under certain terms and conditions.

Subject: Foreign Subsidiaries Holding Shares of Parent

Amended Regulation: Amend the existing regulation to allow a foreign subsidiary of a financial institution to hold shares of its parent under certain terms and conditions (e.g. temporary holding; for the purposes of facilitating acquisitions/mergers by the foreign subsidiary in the foreign jurisdiction).

The Department is assessing whether the changes described above are appropriate for financial institutions and is seeking comments on this proposal.

Explanation: Changes were introduced to the CBCA to allow foreign subsidiaries of companies to temporarily hold shares of their parent under certain terms and conditions (e.g. limited holding period; purpose of the holding is to facilitate transactions by the subsidiary in the foreign jurisdiction).

Subject: Well-being Reports*

Amendment: Add a provision to the financial institutions legislation to require that auditors report transactions that may affect the well-being of an institution to the audit committee of that financial institution.

Explanation: Auditors are currently required to review transactions that may affect the well-being of the institution and to report on these transactions to the CEO, CFO, and Superintendent. There is no explicit requirement for the auditors to report the transactions to the audit committee. The amendment would clarify that auditors are required to report on transactions that may affect the well-being of the institution to the audit committee.

Subject: Number of Auditors of a Bank*

Amendment: A bank holding company is currently required to ensure that each of its subsidiaries has as its auditor the auditor of the bank holding company. The provision would be amended to clarify that each of the subsidiaries of the bank holding company must have as its auditor, or one of its auditors, the same auditor as the bank holding company.

Explanation: Banks are permitted to have two auditors under the current legislation. Questions have been raised as to whether the obligation on bank holding companies to ensure that "each of its subsidiaries has as its auditor the auditor of the bank holding company" precludes a bank that is a subsidiary of the bank holding company from having more than one auditor. The proposed amendment would clarify that a bank that is a subsidiary of a bank holding company may have more than one auditor.

Subject: Terminology*

Amendment: The financial institutions legislation would be amended to update accounting terminology used in the respective statutes. For example, out of date terminology such as "statement of changes in financial position" would be changed to "statement of cash flows". New authority would be also added to the legislation to allow for changes in terminology to be updated over time through regulatory or administrative action.

Explanation: The financial institutions legislation includes a number of references to accounting and other technical terms and definitions. Over time, these technical terms are subject to change. The legislative amendments would update these terms, and the new authority would allow for changes in terminology to continue to be adjusted over time.

Subject: Notice of Meetings*

Amendment: Require financial institutions to send OSFI a notice of the time and place of a meeting of shareholders at the same time as the notice is sent to the shareholders.

Explanation: Currently, if no proxy circulars are filed in relation to a meeting, OSFI does not receive notice of the meeting and consequently, does not know when the annual return of directors and officers is due to OSFI.

Subject: Conflicts of interest*

Amendment: Extend to board committee meetings the existing requirement that directors with a conflict of interest in a particular contract not be present at board meetings discussing the contract, or vote on resolutions to approve the contract.

Explanation: Currently, directors with a conflict of interest in respect of a contract cannot attend "any meeting of directors" while that contract is being considered. The directors should also be expressly prohibited from attending meetings of committees of directors.

Subject: Auditors report and examination*

Amendment: Clarify that both the auditor's examination and the auditor's report to the shareholders be prepared in accordance with Generally Accepted Auditing Standards (GAAS), except as otherwise specified by the Superintendent, and make clear that a reference to the auditing standards anywhere within the Act is a reference to GAAS except as otherwise specified by the Superintendent.

Explanation: Currently, the legislation is not clear with regard to the requirement that the auditor's report to the shareholders be prepared in accordance with GAAS. As well, the statutes are not clear that a reference to the auditing standards within the legislation is a reference to GAAS except as otherwise specified by the Superintendent.

Subject: Vertical short-form amalgamation* [18]

Amendment: Amend the ICA to provide that a company may not use the vertical short-form amalgamation procedure unless both the company and the wholly-owned subsidiary do not have any participating policyholders.

Explanation: This change would harmonize the requirements for horizontal and vertical short-form amalgamation under the ICA.

[18] Note that this change would only be made under the ICA.

Subject: Transfer of business and reinsurance*[19]

Amendment: Amend the ICA requirements for a foreign company transferring or causing itself to be reinsured against all or any portion of risks undertaken by it or purchasing or reinsuring all or any portion of its policies in Canada (except for reinsurance out of the ordinary course of its business). In addition to obtaining Ministerial approval, a foreign company would be required to publish a notice of intention and to make the agreements available for inspection. The Superintendent could require further disclosure of information or shorten the period regarding the publication of the notice of intention or regarding the availability of the agreement for inspection. A transaction could not be approved if it would cause the company's capital to be impaired.

Explanation: This change is intended to harmonize further the regime for Canadian and foreign companies.

[19] Note that this change would only be made under the ICA